The Domestic Stability Pact: Assessment of the Italian experience and comparison with the other EMU countries

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The 1999-2006 versions of the Italian Domestic Stability Pact had many shortcomings and a modest impact with respect to the aim of aligning the fiscal behaviour of sub-national government units with the national commitments under the European Stability and Growth Pact. The Domestic Pact was revised in 2007 and 2008 to tighten the monitoring and sanctions framework and prevent some inefficient behaviour. However, some undesirable features still mar the new regime: no coordination exists between the Domestic Pact and the debt and tax constraints applied to local governments; a clear definition of the contribution of sub-national governments to aggregate compliance with the external rule is still lacking; flexibility has been introduced by means of an artificial reference budget balance; side effects on resource redistribution are ignored; and monitoring and sanctioning remain weak. Remedies for the above shortcomings can possibly be found in the domestic pacts of the other EMU countries. Most of all, the Domestic Pact should be adjusted to the specific characteristics of fiscal decentralization in Italy, where a large fiscal gap exists, revenue autonomy is constrained and a large share of the responsibility for spending is rigid and politically sensitive.

1. Introduction[1]

The constraints imposed on the public finances by the Stability and Growth Pact force the EMU countries to control their budget balances and the stock of debt with reference to general government, i.e. to the consolidated accounts of central government, local government and social security institutions. Control of the public finances thus requires the cooperation of a wide range of entities and not just the commitment of the central government, even though the latter is the only body

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directly responsible at European level for the results of the public finances. This situation is therefore a problem of the supply of a public good: in the absence of incentives, constraints and sanctions encouraging the other entities to contribute their part to the supply of the public good "sound public finances," the ultimate responsibility for financing its production falls on the central government. To guarantee that all the entities called upon to contribute to the results of the public finances do not engage in opportunistic conduct, the EMU countries have laid down various rules of financial coordination known as Domestic Stability Pacts, which are imposed on or agreed with the sector that is most important for the general government budget balances, i.e. local government.

This work provides a preliminary analysis of the various ways in which the sub-national rules are drawn up in general and the possible ways of sharing an external objective at local level (Section 2). Section 3 presents the characteristics of the main sub-national rules adopted by the EMU countries. Section 4 introduces the discussion with reference to Italy, describes the characteristics of Italian decentralization that are relevant to the choice of the fiscal rules for the local authorities, looks at the Domestic Stability Pact rules in force from 1999 and 2006, and presents an assessment of the fiscal rules on the basis of the results of the consolidated accounts. The latest version of the Domestic Stability Pact, introduced in 2007 and corrected in 2008, is described and discussed in Section 5. Section 6 contains the main conclusions.

2. General models of sub-national rules

Rules for coordinating between different levels of government are often adopted in developed countries to regulate financial relationships in contexts of fiscal federalism.[2] Their purpose is to guarantee both macroeconomic stability at national level and the advantages, in terms of greater efficiency, of decentralization at local level (Joumard et al., 2005, p.5). The utility of fiscal rules at

[2] On the problems of the approach to intergovernmental fiscal relationships, see, among others, Ter-Minassian and Craig (1997), Pisauro (2001), Dafflon (2002), Rossi and Dafflon (2002), and Ahmad et al. (2005).

local or sub-national level[3] nonetheless varies with the country's decentralization structure and above all with the nature of the financial links between entities at different levels. Among the most important elements is the presence or absence of wide fiscal gaps (or vertical fiscal imbalances) at sub-national level, or in other words of a large difference between the expenditure assigned and revenue competences, which is financed by central transfers, (Rodden, 2002, p. 672).

The existence of fiscal gaps gives rise, in fact, to a divergence between the local and national opportunity costs of using public funds and therefore encourages excessive local expenditure because it is financed in part by the common pool of state taxes (Weingast et al., 1981). In addition, there is a problem of moral hazard deriving from the insurance effect provided by the presence of a higher-level government entity, the central government, that, faced with local deficits, will eventually intervene with special transfers to make good the deficits or by taking over the liabilities; the ultimate effect is a loosening of the local entity's budget constraint. In fact even an explicit no-bail-out commitment by the central government cannot be considered credible; the government cannot leave sub-national entities in a state of financial collapse, both because they are "too big to fail" (Wildasin, 1997)[4] and because support measures are preferable, including from the standpoint of maximizing the social welfare of the federation (Persson and Tabellini, 1996; Bordignon et al. 2001). If, moreover, the local entities have access to the capital markets, the fiscal gap causes private investors to expect that the state will act as the guarantor of last resort for their debt: the cost of debt is thus also

[3] The term "local" refers to local and regional governments, whereas the term "sub-national" also includes federal states.

[4] The policy indication provided by Wildasin (1997) is to fragment the levels of government even further to the point of creating jurisdictions that are so small the central government can allow them to fail, since the level of local public goods they provide does not produce the sizable and important positive externalities that are produced instead by larger entities and that protect them from the central government's no-bail-out threat. Alternatively, he suggests the use of more generous transfers by the central government than would be justified under a purely efficiency-based approach, thus avoiding the creation of deficits and the consequent make-good intervention by the central government. In short, a second-best solution with inefficient transfers, but without a make-good intervention is indicated as preferable for the collectivity to a second-best solution with efficient transfers accompanied by a bail-out. Pisauro (2001) observes, however, that these measures would aggravate the problem of the common pool.

increased for the decentralized entities, together with the volatility of public expenditure and tax rates.

In short, a wide fiscal gap allows local entities to offload the costs of their fiscal irresponsibility onto the collectivity. This prospect and the impossibility of eliminating the problem of moral hazard suggest the adoption of stringent sub-national fiscal rules (Eichengreen and von Hagen, 1996; Rodden, 2002), which are less necessary, instead, when the decentralized entities enjoy a more balanced assignment of revenue and expenditure powers: the paradigmatic models are the Swiss cantons and the Canadian federation. However, not even this model of fiscal federalism is exempt from the need for central intervention, linked in particular to the assignment of adequate tax bases, the danger of excessive tax competition and a greater sensitivity to the economic cycle, which exposes local authorities to the risk of accumulating deficits in the negative phases of the cycle. Last but not least, the closing of the fiscal gap does not increase sub-national entities' perception of the effects their fiscal choices produce at aggregate level or eliminate the problem of moral hazard: "closing the gap does not necessarily mean closing access to the pool [of tax resources]" (Pisauro, 2002, p.706).

There are many fiscal rules applicable at sub-national level, although none is fully effective in controlling local public finances or exempt from the risk of being evaded.

- *Rules on budget balances*: These are the most commonly applied, with variations in terms of the type of budget considered (forecast, approved, outturn with or without losses carried forward); they have the advantage of being simple but they can be meaningless if some revenue and expenditure items are excluded and if it proves impossible to prevent others from being classified as off-budget items.
- *Expenditure caps*: These are found in the form of ceilings on total or current expenditure or specific expenditure items. On their own they do not make it possible to prevent the formation of debt if some items are managed off-budget, and they can cause allocative inefficiencies if, in order to comply with the ceiling, sub-national entities reduce the expenditure that is most flexible in the short

term, i.e. investment expenditure. Moreover, the fact that local entities are entrusted with politically sensitive expenditure (health care, education, services for old and disabled people, etc.) makes it very difficult to make cuts and thus to comply with the ceilings. Among other things, local public expenditure, precisely because very often it is for personal services, suffers from Baumol's cost disease, which prevents cost reductions and the overall compliance with the cap.

- *Ceilings on the own revenue of sub-national entities*: These can be used both to limit or freeze the authorities' ability to alter tax rates or reliefs, often as a way of punishing non-compliant entities, and to cap the revenue obtainable from a given tax base.
- *Limits on the stock of debt or on the issuance of new debt*: These are often couched in numerical form and are sometimes accompanied by a request for administrative authorizations and guarantees. They can be evaded by transferring debt to other general government entities that are not subject to the limits or to local public enterprises outside general government and by engaging in sale-and-lease-back operations.
- *Restrictions on the type of expenditure that can be financed with debt*: These generally state that only investment expenditure can be financed with debt (the golden rule). In this way the current account is separated from the capital account, with the current account balance including debt service, i.e. interest payments and repayments of principal on the basis of a rule of the pay-as-you-use type. Such restrictions require an unambiguous definition of investment expenditure so as to avoid the transfer of current expenditure items to capital expenditure. Moreover, they do not appear to be able to guarantee the macroeconomic sustainability of the debt (Dafflon, 2002). The second problem could be overcome by a rule that excludes capital expenditure from the balance but restricts it in the aggregate for the various sectors (Balassone, Degni and Salvemini, 2002).
- *Limits on the debt linked to the cost of debt service or indicators of the ability to service the debt* (own revenue, tax bases): These may not be effective in curbing debt if the financial conditions are distorted or manipulated.

The combination of more than one restriction is appropriate when just one, particularly rigid, constraint might give rise to undesirable conduct by sub-national entities: procyclical fiscal conduct, i.e. increases in expenditure in the positive phases of the cycle accompanied by increases in fiscal pressure in the negative phases (ratchet effect), budgetary window-dressing,[5] and the curbing of investment expenditure. The literature suggests overcoming these drawbacks by combining ceilings on budgetary balances with a restriction on own revenue or by defining the balance net of investment expenditure or, lastly, by adopting objectives that are not annual but defined in the medium term so as to permit the offsetting of surpluses and deficits.[6] The need for more flexible constraints can also be met by introducing safeguard clauses or contingency funds, though these may require very large sums to be set aside that to some extent undermine the disciplinary effect of the rule.

However they are configured, the tax rules must constitute a credible commitment on the part of local and national governments. Numerous factors contribute to this, first and foremost how they are established (self-imposition, decisions by central government, multilateral bargaining), the ex ante and ex post monitoring of budgetary data, the ways in which budget forecasts are made, the existence of an independent audit system, the disclosure of data and the sanctions imposed on non-compliant entities. In particular, some types of sanctions are likely not to appear very credible – not only those that are clearly disproportionate, but also those of a financial nature, since, owing to the inevitable problem of moral hazard, an entity in greater

[5] "Such practices include for instance: the reclassification of expenditures from current to capital, to escape current budget balance requirements; the creation of entities whose operations - albeit of a governmental nature - are kept off-budget, and whose debts are not counted against the debt ceilings; the use of state or local government-owned enterprises to borrow for purposes that should be funded through the relevant government budget; the use of debt instruments – such as sale and leaseback arrangements – that are not included in the debt limits; the resort to arrears to suppliers, which are typically difficult to monitor for inclusion in the public debt ceilings" (Ter-Minassian and Craig, 1997, p. 166).

[6] Dafflon (2002) stresses the need for the time horizon required for the rebalancing of the budget to correspond with the time horizon of local level administrative mandates: if these periods fail to coincide, a phenomenon of financial illusion would be introduced together with an incentive for local politicians to overspend. Moreover, if the adjustment in the early years of the period considered were modest, it would have to be much larger in the last year of the constraint's application, so that it would risk not being sustainable by the local government.

difficulty is more and not less likely to receive additional help (Joumard et al. 2005).

Not only administrative procedures can discipline local governments' fiscal conduct but so can financial markets by limiting access to financing or increasing the cost of debt (Breton, 1977). However, this disciplinary effect is produced under particularly stringent conditions that are rarely met in practice regarding the availability of information, the openness of markets, and the absence of moral hazard. Moreover, there is the problem of the lag or limited reactivity with which local administrators perceive market signals, which are subject to sudden discontinuities (Ahmad et al., 2005).

To conclude, the choice of sub-national fiscal rules should be made in relation to the objectives to be achieved (containing the size of the local public sector, sharing of external constraints, sustainability of the debt, an incentive for allocative efficiency) and, where there are several objectives, there should be several mutually consistent rules. In particular, if one of the objectives is to share an external constraint, such as the Growth and Stability Pact, between different levels, it is necessary to inquire into the possible forms this domestic rule can take in a decentralized system. In order to be consistent, the domestic rules must replicate, in some respects, the structure of the external constraint (e.g. objectives expressed in terms of the same variables, the use of data comparable to those of the national accounts, and congruent time horizons). In particular, since the external objective is a budget balance, it would be desirable, especially in decentralized structures where there is some degree of local fiscal autonomy, for the domestic control variable also to be a balance and not, say, a cap on expenditure. Moreover, since the purpose of the constraint is to control the general government balance and not the size of the public sector, a constraint applied to balances should not be accompanied by severe restrictions on fiscal autonomy. In fact, insofar as the fiscal rules are applied in a context of decentralization, they must leave margins of autonomy with regard to revenue and expenditure decisions. In line with the structure of the external constraint, it would appear most suitable to supplement it with constraints on the balances and debt of the local entities.

The sharing of an external objective gives rise to the problem of determining the contribution that each category must make to the collective effort. This can be done either by establishing the share of deficit and/or debt reduction to be borne by each category (regional and municipal governments) or by establishing only the share required from the highest level in the hierarchy of sub-national entities (regions/states); the choice between the two models depends on the types of relationship existing between the various levels of government. In the first case *(Figure 1a)* each category of local government must find, in turn, a way of sharing the objective internally.[7] In the second case *(Figure 1b)* the category of regional/state entities will establish the share of each region/state and these, in turn, will agree the contributions required from each lower level entity belonging to its jurisdiction. The system of monitoring and control also depends on the type of sharing of the external constraint chosen: in the first case forms of peer pressure are important while in the second it should require the intervention of the higher-level local entity.

The ways of sharing the objective within each category or higher local entity must take account of the structural disequilibria between the different areas (Bosi et al, 2003) and can be defined either as part of a formalized process of cooperation or with more sophisticated methods, such as the creation of a market in deficit permits (Casella, 1999)[8] in which entities compare the cost of reducing their own deficit with the market price of permits and these are exchanged by way of direct bargaining or auctions. This mechanism could allow an efficient allocation of deficits and be regulated on the basis of the central government's macroeconomic objectives. It is open to some methodological criticisms, however (Patrizii et al., 2006; Rossi and Dafflon, 2002; Balassone and Franco, 2001), especially as regards the initial distribution of permits, the need for sufficient competition in the market for permits, the hypothesis of perfect substitutability between entities' deficits, and the distortions introduced by considerations of a political nature that can influence the decision to buy permits.

[7] For Italy, such a proposal was supported by Bosi et al. (2003).
[8] For Italy, such a proposal was supported by Commissione Tecnica per la Spesa Pubblica (2001) and by Giarda et al. (2005), with special reference to debt financing of municipalities' capital expenditure. More recently the proposal has been discussed again in ISAE (2007).

3. Models applied in Europe

The various EMU countries have followed many different paths in attempting to make the fiscal policies of their decentralized entities consistent with the constraints of the Stability and Growth Pact: in some cases marginal changes have been made to existing rules; in others new rules have been introduced in a specific legislative context. In some countries the need for the decentralized entities to contribute to achieving the aggregate objective arose even before the start of EMU. In the mid-1990s Austria, Belgium, Germany and Spain already had a level of local deficit that contributed to causing total deficit to diverge from the Maastricht target *(Table 1)*. The fiscal rules introduced at that time did not always bring the intended results. In the last ten years Austria and Belgium have turned the local government balance into a structural surplus. The consolidation of the budgetary balance in Spain was due instead to the results obtained by the central government and the social security institutions, while the deficit of the autonomous communities (regions) was not reduced significantly and the local governments, which had been in balance in 1995, recorded a small deficit from 2002 onwards. In Germany the deficit of the *Länder* continues to represent an important share of the total net deficit. In other countries the problem of the consistency between the external objective and the fiscal conduct of the decentralized entities emerged after the start of EMU (Finland and the Netherlands).

As regards consolidated debt, the local component is less than ten per cent of the total in some countries (Austria, Belgium, France and Italy); in the Netherlands and Spain, its share is about 15 per cent, while in Germany it is about 40 per cent. In general the last ten years have seen a tendency for the share of local government debt to decline, whereas, as will be seen in Section 5, the tendency in Italy has been in the opposite direction, with local government debt rising from 4.3 per cent of the total in 1995 to 7.3 per cent in 2005.

This range of results is due to a variety of factors, but it is possible to identify the main factors in each of the paths followed by the countries considered in disciplining and coordinating the budgetary results at the different levels of government.

As shown in Section 2, the value of fiscal rules at local and sub-national level varies with the structure of decentralization and the nature of the financial links between the entities at the different levels. The degree of decentralization, measured in terms of the amount of expenditure managed at local level, is generally used as an indicator of the extent of fiscal federalism. Among the countries considered, Belgium, Germany, Finland and Spain can be considered as the most decentralized, with local government's share of total expenditure ranging from 39.4 per cent in Finland to 53.4 per cent in Spain. In the last 10 years the degree of decentralization has on average increased in all the countries considered except the Netherlands *(Table 2)*.

On the financing side the total share of sub-national entities' own taxes is generally small (between 10 and 30 per cent of local tax revenue), compared with the use of instruments of derivative finance such as vertical and horizontal transfers and tax sharing, thus reducing the financial responsibility of sub-national entities. However, the decentralization of revenue has been considerable both in Spain and in Italy *(Table 2)*. Moreover, the autonomy implicit in own taxes and tax sharing depends also on the freedom that is granted at the local level in determining tax rates, the tax base and tax reliefs. The potential fiscal effort is very limited in Austria and Germany. Instead, Belgium and Spain and most of the unitary countries enjoy greater fiscal autonomy. Spain has a high degree of fiscal autonomy compared with the other countries considered, with tax rates and bases that can be manoeuvred in excess of 50 per cent of the revenue for the regions and 77 per cent for the local authorities *(Table 2)*. Consequently, if Spain is excluded, in most of the countries, and especially in Austria and Germany, responsibility for expenditure does not appear to be matched by sufficient responsibility on the financing side, thus potentially generating common pool fund problems.

As regards the constraints, all the EMU countries have set a constraint on the annual budget balance, both at the levels of intermediate government (federal states or regions) and at the lower levels (local governments). Austria, Spain, Finland and Belgium have introduced a multi-year time frame, complying with the objectives established at national level in the various European Stability Programmes. In Germany, the Netherlands, France and Finland the compass of the constraint at the lower level is limited to the current account balance, while in Austria and Spain the constraint includes some off-budget items *(Table 3)*.

In most countries the constraints on the balance are accompanied by constraints on the debt of the local entities fixed by the higher level of government; by contrast, this is explicitly excluded in Belgium and the Netherlands, but the possibility of borrowing can be limited if the balanced budget constraint is not complied with. In Spain the constraint on the debt is self-imposed; in France, Germany and Spain debt is subject to the golden rule at the local government level. In France and Germany the constraint is numerical for the issue of new debt, while in Spain there is also a ceiling on the stock. In Belgium the constraint is expressed in terms of a restriction on interest payments. In all the countries recourse to local government debt is restricted to certain uses of the funds and is often subject to central government approval. In Finland there is no constraint on the debt. Constraints on expenditure are much less common and, among the countries considered, only Germany and Belgium have provided, as an additional measure, a ceiling on the growth of expenditure at the local level. Although there is no specific rule for revenue, the degree of fiscal autonomy constitutes an implicit constraint on the financing of local entities. The application of a minimum (or standard) rate and a maximum rate for local taxes amounts to respectively a lower and an upper limit on the entities' fiscal revenue. The Netherlands does not provide for any restriction on tax rates and the same is true of Finland for most local and revenue-sharing taxes.

As regards the various methods used to define the constraints, it is possible to distinguish the countries that have used a cooperative approach (Belgium, Germany and the Netherlands) from those, such as Italy, that have imposed budgetary rules. In some countries (Austria and Spain) the rules are not imposed but negotiated.

In 1992 Belgium, as part of its plan to converge on the Maastricht parameters, began to coordinate its budgetary objectives at the different levels of government. In particular, the CSF (Conseil Supérieur des Finances), whose members include representatives of the federal government, the regional government (3 regions and 3 linguistic communities) and local government (10 provinces and 589 municipalities), established, in a process of cooperation between the centre and peripheral entities, the contribution of each level of government to the budget constraint defined in the convergence plan. The objective for all the levels of local government has been fixed, since 1999, as a balanced budget; and an agreement of 2005 provides for the budgets of the regions and the municipalities to be in surplus. No special constraints are envisaged on the issue of debt by individual local entities, but the definition of the balanced budget and the results in terms of surpluses in the last few years have clearly contributed to a sizable reduction in the debt at local level, both as a ratio to GDP and as a share of total debt.

The cooperative approach has not produced such satisfactory results in Germany.[9] The assignment of responsibilities to the decentralized bodies is not well specified, so there is a strong incentive for free riding. In particular, management of most of the devolved functions is shared between the federal and regional governments, which reduces transparency in the assignment of roles and specific government accountability. Further, the principle of linkage between administrative functions and financial costs, combined with the relative lack of local financial autonomy, engenders moral hazard and the host of problems connected with the common pool fund. A Financial Planning Council was instituted to coordinate budget planning between the federal government, regional governments, and other local bodies. Based on an agreement the Council puts forward suggestions to define the budget targets. In any event, both the federal government and the regions remain independent and autonomous in setting their budget policies; their only constraint is accounting equilibrium. As for debt constraints, like a number of other countries Germany has instituted a golden rule for local government budgets. In the mid-1990s the relatively relaxed local budget constraints and the existing coordination procedures began to seem insufficient to ensure compliance with European rules. Following the financial difficulties that emerged in 2001, in 2002 a new agreement was reached setting the objective of a balanced budget in the medium term both for the federal government and for the *Länder* and enhancing the coordination

[9] In addition to the federal government, the Constitution provides for 16 regions (*Länder*) e 13,000 municipalities.

functions of the Financial Planning Council with specific regard to European constraints. The Council is empowered to rule on local government budgets' compliance with the Stability Programme and to make recommendations to correct their fiscal behaviour. Further, federal government, *Länder* and municipalities agreed on the division of the net borrowing target between levels of government: 45 per cent to the federal government and the remaining 55 per cent to regional and local authorities. Finally, a spending curb was instituted both at federal and at regional level so as to achieve the general government budget balance.

Consensus and cooperation also play a major role in another country in which formal budget rules apply, namely Austria.[10] All levels of government must do their share to achieve budget equilibrium, through the machinery of the "fiscal sharing act". The objective is to ensure the financial sustainability of the expenditure for which each entity is responsible. The need to involve local governments in meeting the Maastricht standards resulted in a first informal agreement in 1996 and a proper "Domestic Stability Pact" in 1999. As a preliminary, the proportions in which the various levels of government must contribute to deficit reduction are set for the entire duration of the Pact. The various contributions are quantified on the basis of deficit targets for each year. For local administrations, the distribution is not by individual entity but according to resident population and the economic condition of the region to which the entities belong. This mechanism makes it possible to negotiate deficit shares between regions, between the local governments within each region, and between the entire set of local governments in one region and in another. It also permits budget coordination, ensuring a certain degree of flexibility. Coordination is on two planes: one involving different institutional levels and a second, through Committees, involving relations between individual regions and the local governments within

[10] The Austrian federal state comprises 9 regions (*Länder*) e 2,359 local communities, and the constitution mandates the sharing between federal and regional governments of the functions relating to state sovereignty, while all functions not attributed directly to the central government are automatically the responsibility of the regions. Local administrations are responsible for administrative functions delegated to them from higher levels. As in Germany, this federal structure produces greater problems in controlling local budgets. In Austria it generated fiscal gaps generally in favour of the local governments until the mid-1990s, but the situation was then inverted and local governments began to run deficits.

them. The process involves setting budget targets and short-term fiscal policy objectives and monitoring deficits and debt, for prompt detection of any overall excessive deficit of the general government. The Committees suggest adjustment measures and if necessary decide on the sharing of any penalties.

Spain also has a fiscal rule, but here too cooperation is decisive. In the last few years very extensive decentralization has been carried out, but there has been a narrowing of the fiscal gap and a reduction of moral hazard for local governments, making it possible to reconcile decentralization with budget stability at sub-national level. During the 1990s fiscal policy for different levels of government (17 autonomous communities, or regions, and 8,102 municipalities) was based on coordination under the Fiscal and Financial Policy Council, with representatives of the Autonomous Communities. The Council also had the purpose of coordinating investment and debt policies and resource distribution. Constraints were set, mainly on debt issuance. Local governments were subject to the golden rule and to central authorization, and interest payments could not exceed 25 per cent of current revenues. These constraints did not prove to be particularly effective, and the control of local budgets was achieved mainly on the expenditure side, through bilateral negotiations that were lacking in transparency. In 2001 the need to institutionalize coordination induced Spain, too, to pass a national law instituting a Domestic Stability Pact (*Ley General de Estabilidad Presupuestaria*). The central government unilaterally sets the consolidated budget target and the overall objective for each level of government, based on a multi-year plan approved by Parliament and subject to the oversight of the Council. The Council and the National Commission of Local Administrations are responsible for allotting the deficit and debt targets among the various entities. The different levels of government pledged to maintain budget balance or surplus, but each local authority retains full independence in budgetary decisions. The Pact was revised in 2005 to attenuate some elements of rigidity that might create incentives for pro-cyclical policy and reduce budget transparency through off-budget transactions. For the central and sub-national governments, budget balance was no longer defined on a yearly basis but over three years, in accordance with economic forecasts. As an exception, the central government, the Autonomous Communities and largest city governments may run additional deficits to fund investment projects (the golden rule). Further, negotiations were envisaged to set the general objectives for the various levels of government, with the institution of a phase of bilateral consultations between Autonomous Communities and central government and the reinforcement of the role of the Fiscal and Financial Policy Council of the Autonomous Communities and of the National Commission of Local Administrations.

The differences in the achievements of the Domestic Stability Pacts depend in part on procedural features, in particular the monitoring of results. In Belgium, responsibility for the overall budget outturn of local governments is assigned to the federal states (regions). The Conseil Supérieur des Finances is responsible for monitoring fiscal policy in the regions and checking its execution, in concert with the regions and municipalities, through monthly exchange of data. Control on budget equilibrium at municipal level is assigned to the provinces, which also have the power to impose budget adjustments (spending cuts or tax increases) where the objectives are not met. The budget targets are made more credible by the presence of an independent agency, the Federal Planning Bureau, for forecasting macroeconomic and budget variables for the federal budget process. Austria and the Netherlands also have independent institutes, and in those countries there is, on average, less deviation of budget and economic outturns from the initial forecasts.

In Spain the checking of budget objectives is entrusted to a central government agency that is generally responsible for public accounting. The Finance Mininstry monitors the financial adjustment plans that the Autonomous Communities must present yearly. The Fiscal and Financial Policy Council, however, has the power to verify the implementation of devolution and compliance with fiscal rules at regional level. To tighten monitoring, the revised Domestic Stability Pact provides that in preparing their budgets the various administrations must supply all information necessary to verify their compatibility with the targets; the information must be made available through a public database.

In Germany, it is the procedure itself that appears to weaken the Domestic Stability Pact. Hierarchical ex-post controls of compliance with the objectives is lacking, since budgets are subject only to checks at the same level of government, while the State Audit Office carries out only administrative controls. City governments, in their budget process, are considered as parts of their region, and their budget policies are subject to the monitoring of the interior ministry of that region. Germany shows, on average, a wider discrepancy between forecasts and outturns, presumably due to a relative lack of independence in making macroeconomic forecasts and to the fact that the budget is drafted and the outturn measured on a cash rather than on an accrual basis.

Ex post reconstructing the accounts according to ESA95 standards weakens the procedure for setting targets and, even more so, undermines budget control not only in Germany but also in France and Italy. In the other countries, there is a mounting effort to make the budget targets at the different levels of government consistent with the consolidated budget objective set in the stability programme. In this regard, Belgium, Austria and Spain refer more explicitly to accounts drafted according to ESA95.

Sanction procedures differ considerably from country to country. Austria, Belgium, Germany, the Netherlands and Spain provide for financial sanctions, such as reduced transfers, and/or administrative penalties, such as the limitation of financial independence. In Belgium the regions are subject to a sanction mechanism, and the Conseil Supérieur des Finances can ask the federal government to limit their borrowing capacity. In Spain and the Netherlands, local governments' access to credit depends on having a balanced budget.

In general, when there is a violation, deviations from the adjustment plan have to be justified, but in Finland, France, Germany and the Netherlands no explicit sanctions are provided for. Among the countries examined here, only Spain and Austria provide for the allotment of a European sanction between the non-compliant jurisdictions. In Spain, the criterion for allotment is decided ex post. In Austria, the sanction applies, with joint and several liability, to all the entities, but this has proved not a particularly credible system for eliminating free riding. As a rule, these collective sanctions are an incentive to maintain a balance between regional surpluses and deficits but do not rule out the possibility that it will always be the same surplus regions to offset regularly excessive deficits in others. That is, this mechanism takes no account of the fiscal sustainability of individual entities, much less of the quality of their spending (ISAE, 2007). Spain also has a no-bail-out clause that explicitly rules out any obligation on the part of the central government to salvage insolvent local governments. Austria has a safeguard clause with respect to the budget constraint only in the case of severe recession.

As an alternative to cooperation, local fiscal discipline can be imposed from above, as in France, where during the 1990s a series of laws were enacted offering a degree of fiscal decentralization, and local financial autonomy was reinforced, but no real Domestic Stabilty Pact was ever adopted. There are no limits on local debt, but there are implicit constraints stemming from the balanced budget rule and the investment accounting standards. On the one hand, the rule requiring a balanced budget on current account makes application of the golden rule mandatory. On the other, the charging of depreciation to the capital account requires a current account surplus to cover past investment, thus limiting new debt to the financing of new investment only. Budget controls are administrative and are performed by the local sections of the State Audit Office (*Chambre Régionale des Comptes*). They examine both the ex-ante and ex-post budget balance. If the deficit exceeds 5 or 10 per cent of current revenue (depending on population), the *Chambre* must suggest corrective measures. The imposition of this rule on local public finances involves some elements of risk, in that the accounting aggregate to which it refers is not exhaustive of the local budget, which also includes transactions of entities delegated by the local authorities to perform certain functions that are outside the consolidated budget (such as outsourcing, public entities created jointly by more than one government, and unions of municipalities). So far, local accounts do not appear to have been the source of any serious concern for compliance with the EU constraints, but the good performance at local level has been assured by central government transfers in cases of budget difficulties. French decentralization is marked by highly differentiated fiscal gaps that require not only vertical but also horizontal transfers, and if problems in complying with the European standards arise, unless the institutional relationships and budget rules are modified, the burden will continue to fall on the central government (Gilbert and Guengant, 2002).

4. The Domestic Stability Pact in Italy

Italy has moved very far towards decentralization in the last few years. At present, sub-national governments are responsible for about a third of total general government spending *(Table 4)*. Especially significant is the fact that some 80 per cent of direct general government investment expenditure is effected by the local administrations, and 45.9 per cent (or 1.3 per cent of GDP) by municipalities alone.[11] Capital expenditure thus represents a significant portion of municipal and regional budgets (larger for the former than for the latter), and it strongly affects overall budget results, especially for municipalities (ISAE, 2007). These sub-national authorities, moreover, have jurisdiction over some politically sensitive spending items (health, education, welfare) and have a high degree of structural rigidity on the spending side, especially the municipalities.

The tax or revenue powers assigned to the local authorities are still very limited, however. Own taxes account for less than half of total revenues, cover less than half of current spending, and are only partially under the control of the local bodies. Since tariff revenues are still relatively insignificant, central government transfers remain paramount.[12] So there is a substantial fiscal gap, which the literature associates with the need for stricter fiscal rules, joined with the necessity of coordinating local finances in order to comply with the external constraint of the Stability and Growth Pact. To resolve the problem of free-riding in the provision of the public good “sound public finances,” Italy has taken a top-down approch in which the contributions required of the various segments of general government are not specified[13] but annual constraints are set on every single sub-national unit, differentiated in some years between the regional and the other authorities. This way of sharing the Stability and Growth Pact burden derives essentially from the strong relations, including financial relations, between the central government and each of the sub-national

[11] Direct central government investment spending is less than 0.4 per cent of GDP. But most of the transfers to finance investment by other general government bodies come from the central government budget.
[12] For purposes of international comparison, however, it should be noted that such transfers include VAT sharing, which some countries (Germany) count as own resources.
[13] The technical reports accompanying draft finance acts give only indications on the effects in terms of deficit reduction that should come from the application of the Domestic Stability Pact.

units, which prefer to deal not with the authority immediately above them but directly with the central government. The main defects of this approach consist in the lack of clear specification of the objective that the local authorities should attain and in the rigid constraints that are set on the individual governments, which cannot effect any offsets between one another (e.g. between municipalities) or within a jurisdiction (e.g. the municipalities of a given region). They could even have incentives for “creative accounting” (Ter-Minassian and Craig, 1997).

The rules of the Domestic Pact have always been determined during the final phase of the budget process, i.e. when the size of the budget adjustment is being decided. Only twice was the course of direct negotiation with the local authorities taken.[14] The lack of direct talks in the initial phases of the budget process and of a clear prior agreement between the parties has been one of the causes of the numerous ex-post amendments to the Pact, year after year. As *Table 5* shows, the entities covered, the planning targets and how they are calculated, sanctions, and type of monitoring all changed every year from 1999 to 2007.

4.1. The changing rules of the Domestic Stability Pact, 1999-2006. Groping about in search of some kind of equilibrium, Italy made practically yearly revisions of its Domestic Pact, which created problems for local planning and imposed adjustment costs. The budget constraint, originally identical for all sub-national units, was diversified in 2002 between regions and other local authorities. In turn, some municipalities and other local units with population below a given threshold were excluded from compliance checks in some years. Finally, since 2002 special rules have applied to the autonomous provinces of Trento and Bolzano and to the special-statute regions.[15]

[14] In 2002 the Domestic Stability Pact for the regions was decided on as part of the State-Regions accord on health expenditure of 8 August 2001 and formally enacted as Decree Law 347/2001. In 2007 the Pact was the subject of explicit negotiations between central government and local authorities (26 September 2007).

[15] By 31 March each year these authorities must agree with the Ministry of the Economy and Finance on a three-year spending plan. Up to 2003 the agreement involved only current expenditure (actual outlays). From 2005 on it covered capital spending as well (thus, actual outlays and commitments) and was subject to the general limit of 2 per cent of spending or the constraint applying to ordinary-statue regions. If no agreement is reached, the Domestic Stability Pact rules for the other local authorities apply. The authorities themselves decide which regime to apply to the smaller units within their territory. The accounts of the special-statue regions and autonomous provinces too are subject to monitoring.

Excepting the first two years of application, 1999 and 2000, when the Pact required a reduction of the aggregate deficit on a current programmes basis for the subject entities as a group, through 2006 it required each unit to correct the budget balance from previous years or else set a limit – expressed as a ceiling with respect to historical values – on the growth of current expenditure. In particular, since 2002 the constraint for regional governments consisted only in an expenditure cap. As section 2 shows, the spending constraint actually only limits the expansion of the local public sector and does not directly serve to share the burden of the European pact. At least where it was combined with a constraint on the budget balance, its presence within the Domestic Pact was justified as a correction to the budget balance itself. Past outturns, in fact, are not representative of an entity's actual fiscal virtue, because the scope for tax autonomy is so small and revenue and expenditure trends are partially random.

In 2005 and 2006, in line with the controlled growth of overall general government spending, the Domestic Stability Pact was rewritten for all sub-national entities, with a new constraint on their expenditure calculated as a ceiling on spending growth, for the first time including capital spending, and distinguishing between virtuous and unvirtuous entities. For 2006, in addition, differentiation between current and capital expenditure was required, the former to be contained and the latter augmented, so as to improve the quality of local govenrment spending.

Except for the first two years, the limits have always been determined on the basis of historical expenditure, never referring to one-year projections, the actual planning horizon of local authorities. Moreover, a growing number of items have been excluded from the ceilings. For regions, the exemption of health care expenditure restricts the Pact's applicability to just a third of total spending. The exemptions comprise capital expenditure, a number of the least discretionary budget items (e.g. transfer payment revenues and earmarked expenditure financed by transfers), and extraordinary expenditure. Possible outsourcing of public activities, prompted in part by the fiscal rules, has almost never been considered. Only the 2002 Pact established a method of calculating the reference values that included outsourced spending (Law 448/2001, Article 24.4 bis).

What is more, the monitoring system has been extremely weak and at first it relied mainly on a sort of peer pressure, with central government controls applied only to the larger entities and a sample of smaller ones. Information is neither complete nor timely. Moreover, it lacks transparency. The accounting rules are not the same as those for the European pact (ESA95). Sanctions have been quite mild and changeable, ranging from a share in any EU fine (1999) to incentives for the virtuous authorities in the form of lower interest rates on loans from the Deposits and Loans Fund (2000-2001), to administrative prohibitions on non-compliant units. Through 2007 publication of the list of non-compliant entities was never envisaged, and the sanctions were never applied.

The Pact's constraints come on top of other external constraints on local debt and taxes under earlier legislation or special clauses in the national finance laws. The tax autonomy of sub-national government units has always been partial, the possibility of determining the rates and deductions on certain taxes being restricted to a very narrow range. In some years (2003-2005) these limits were transformed into outright caps on revenue, as a consequence of the finance laws' provisions freezing local tax rates.

Local authorities' borrowing has been regulated by many legislative acts over the years.[16] Sub-national bodies may finance investment expenditure by borrowing from the Deposits and Loans Fund or from other financial intermediaries or by securities issues. This golden rule is accompanied by administrative obligations (notification, the requirement to submit a financial plan), constraints (no central or regional government guarantee, restrictions on yields of local bonds with respect to Treasury securities), and guarantee requirements (guaranteed repayment out of current revenue). There is a cap on the expansion of the local authorities' debt in the form of a limit on the ratio of interest payments to revenue.[17] Local debt has never been

[16] Law 142/1990, later incorporated into the local government code (Legislative Decree 267/2000). Law 403/1990 abolished the requirement that local authorities apply for credit first to the Deposits and Loans Fund. Law 155/1989 made loans for local investment conditional upon approval of a financial plan (additional conditions were laid down in Decree laws 504/1992 and 528/1993 and Law 724/1994). Ministerial decree 152/1996 regulates securities issues by local authorities.

[17] At first the limit was 25 per cent (Article 204 of the local government code). It was lowered to 12 per cent in 2004 (Law 311/2004, Article 1.4) and then raised to 15 per cent in 2006 (Law 296/2006, Article 1.698).

explicitly covered by the Pact; references to it are indirect and always couched in terms of rewards and sanctions.

Essentially, the rules in force from 1999 through 2006 were ambivalent. On the one hand they were quite rigid (reference to annual figures, no safeguard or cyclical adjustment clauses, no rainy-day funds), but on the other they lacked stringency (exemption of increasing numbers of revenue and expenditure items, no consideration of outsourcing, weak monitoring and sanctions, lack of information transparency). Thus the high degree of compliance found by the State Audit Office may be best interpreted as the consequence of the mildness of the rules rather than the virtuous behaviour of the authorities. In its yearly reports to Parliament, the Audit Office found a more than satisfactory, and increasing, degree of compliance, in that every year the results were better than the planning targets, above all for regions and provinces.

However, this positive judgment is belied by a reading of the public finance aggregate that is relevant to European controls, namely general government net borrowing. The aggregate excessive deficits that Italy ran from 2003 to 2006 were not entirely the doing of the central government. Sub-national governments also contributed, while the social security institutions almost always turned in a positive balance *(Table 6)*. From 1998 to 2006 the net borrowing of local authorities was lower (in proportion to GDP) than the central government deficit, but it gradually if irregularly worsened over time, and together with the deterioration of the central government finances this produced, in 2001 and then from 2003 onwards, overshoots of the Stability and Growth Pact ceiling. To comply with the European standards, central government net borrowing was lowered from 3.82 per cent of GDP in 2005 to 2.72 per cent in 2006, but that of local governments rose from 0.85 to 1.13 per cent.

Responsibility for the worsening balance is not shared equally among the various sub-national authorities. The largest role in the growth of general government net borrowing was played by regions and the local health units. And while the deficit of the provinces is small if growing, that of the regions and health units is more substantial (0.54 and 0.25 per cent of GDP, respectively, in 2006) and ranges from modest surpluses to large deficits. Net borrowing by municipalities, by contrast, has trended downwards since 2004, being cut by 50 per cent in three years.

It might be presumed that the different types of constraint imposed on the different sub-national units contributed to the difference in budget performance. The constraint on the regions has always been especially weak, because since 2002 there has only been a ceiling on current expenditure, and with exemptions for a large number of items, including health care. Even in 1999-2001, however, when the constraint called for containing the deficit, the regional balance had swung back and forth between surplus and deficit.

For municipalities and provinces, the worst results came in the years from 2002 to 2004, when the Pact regulated the financial balance with a golden rule that exempted capital expenditure. In 2002 the constraint was so mild that the deficit actually increased by 2.5 per cent with respect to the 2000 outturn; in 2003 the target for the municipalities was merely an "improvement" on the balance registered in 2001. Performance more in line with the aim of curbing the general government deficit was achieved with the application of limits to final expenditure in 2005 and 2006, but these distorted the composition of expenditure, with a reduction in capital spending, especially for fixed capital formation, which municipalities cut by 8.3 per cent and provinces by 6 per cent. The next year, the caps distinguished between current and capital expenditure, stabilizing municipal investment and spurring that of the provinces, which rose by 4.2 per cent. Neither the spending cap nor the constraint on the budget balance, by contrast, appears to have affected current expenditure, which rose by an average of 3.7 per cent per year in municipalities and 8 per cent in provinces.

Finally, it is worth observing the changes in the consolidated debt of local administrations over the years of the Pact *(Table 6)*, even though this is governed by outside rules. The debt of the sub-national units has never been a large component of total general government debt (6.9 per cent in 2006). But between 1999 and 2006 there was a considerable increase, as local debt more than doubled in proportion to GDP and rose from €32.7 billion to €108 billion, while central government debt rose by 17.6 per cent. Local government debt thus increased even in the years when total general government debt diminished, so that its role in the overall expansion of debt was certainly significant. Admittedly, the jump in debt registered between 2002 and 2003 was largely an accounting change, reflecting the reclassification of the

Deposits and Loans Fund outside the general government sector, but even so local government debt increased by two percentage points between 2003 and 2006, from 5.35 to 7.33 per cent of GDP; at the same time, the debt of regions and municipalities rose from just over 1 per cent to about 3 per cent of GDP. The fastest rise was in provincial debt, which nearly doubled.

In conclusion, the Pact plus limits to the taxing and debt-contracting autonomy of the sub-national jurisdictions did not succeed in controlling the net borrowing of provinces and above all of regions; it did not affect the accounts of municipalities until the last few years, and only at the cost of a distortion in the composition of expenditure; and it failed to contain the debt trend of local government as a whole.

5. The new rules of the Domestic Stability Pact for 2007-2010

The new Pact introduced by the 2007 and 2008 finance laws covers the period through 2010. The rules for the ordinary-statute regions are not much changed from the past, save for the return to a limit on final expenditure in place of separate caps on current and capital spending. The new Pact envisages experimentation with the regions and autonomous provinces with a view to taking the financial balance as the reference. Starting with 2008, the other regions too can use this aggregate, on condition that the experimentation has shown positive results for the attainment of the public finance targets.

The main changes in 2007 involved the treatment of provinces and of municipalities with more than 5,000 population, which were subjected to a constraint on the final budget balance, which must be complied with in drafting the budget. In calculating the target balance, all budget items are included, including investment expenditure (only credit collection and loan disbursements are excluded). The new Pact distinguishes between virtuous and non-virtuous administrations with reference to the average result on a cash basis in the three years from 2003 through 2005 and differentiates the “annual adjustment” between the two.[18] For units

[18] Actually, this is not an annual adjustment, because it does not correct the budget balance for the reference year on a current programmes basis but bears on a past average. Further, the calculation is not linked to actual measures taken by the local authorities but serves only to determine the target balance.

averaging a surplus, the annual amount of the "adjustment" for 2007 is determined exclusively on the basis of average current expenditure in 2003-2005, and no adjustment is required for 2008. For those running deficits on average, however, the adjustment is a weighted sum of the average current expenditure for 2003-2005 and of the average budget balance for those years. Hence, the adjustment is proportional.

The inclusion of average cash outlays as a factor in determining the size of the adjustment can be read as a proxy for the size of the entity involved, in order to differentiate the requirement among entities with the same absolute budget result. The spending cap goes beyond simple compliance with the European Stability and Growth Pact and sets Italy's domestic rules apart from those of much of Europe. Implicitly, this type of fiscal rule seems to aim at limiting the size of the local public sector, which is probably necessary in Italy in that past performance does not accurately reflect the fiscal position of these units.

The target balance is then calculated both on a cash and on an accrual basis. It consists of the average balance (cash and accrual) for 2003-2005, increased by the amount of the adjustment and reduced (for the 2003-2005 average) by any proceeds (on a cash and on an accrual basis) from the disposal of assets in order to pay off loans. Also, for municipalities only, a ceiling is placed on the size of the adjustment each year, which must not exceed 8 per cent of the 2003-2005 average of final expenditure (net of loans granted). Finally, starting in 2008, municipalities and provinces with a budget surplus will benefit from a further reduction in the calculation of their target balance, if they made large asset disposals in 2003-2005.[19] The arithmetic of the 2008 Pact for municipalities is shown in *Table 7*. That for the provinces is similar, save for the lack of a ceiling on the size of the adjustment.

The 2007 Pact has no flexibility, and for effectiveness it requires that the budget constraint to which it applies itself be rigid. But given a large fiscal gap, rigid expenditure commitments and limited tax autonomy, this requirement cannot be met. Recognition of this rigidity prompted the

[19] If the 3-year average of capital revenue from disposals of real estate and securities (not counting those earmarked for the early repayment of loans) is above 15 per cent of average final revenue, the target adjustment amount is reduced by an amount equal to the difference (if positive) between that revenue excess and the annual size of the adjustment, calculated using the parameters laid down by the 2007 Finance Law.

introduction, for 2008-2010, of a new, more flexible way of determining the balance to be used both in calculating the adjustment and in calculating the budget objective. The new balance, described as on a "mixed accrual basis", is defined as the sum of the balance on an accrual basis for the current account and on a cash basis for the capital account (net of the proceeds of credit collections and of outlays for loans granted).

The new version of the Pact improves monitoring over all local governments and modifies the sanction machinery, which now envisages the automatic raising of some local tax rates (the regional petrol tax and automobile taxes, the municipal surcharge on income tax and the provincial transcription tax) and publication of the list of non-compliant authorities. The fact that the sanctions are automatic toughens the Pact significantly; until now, there had been ample scope for discretion, undermining its credibility. Still, the fact that sanctions are not commensurate with the magnitude of the violation is a major incentive for overshooting the budget objectives (Zanardi, 2007).

5.1 Observations on the Domestic Pact's general approach. First, one is struck by the backward-looking design of the fiscal rule. Reference to the average balance for 2003-2005 has the virtue of preventing opportunism on the part of the local authorities, which can no longer affect those figures. But it also binds the control of local finances to results that will recede further and further in time but which are assumed to be representative of "a financial situation that is correctly framed with respect to the determination of expenditure requirements and/or the adequacy of the fiscal effort" (Bosi et al., 2003, p. 9). However, this backward-looking approach does not necessarily reward the authorities that make the greatest fiscal effort or exert the most control over spending, while it can reward those that receive the most transfers. Further, the failure to consider current programmes budget projections essentially eliminates incentives to improve resource use in the future and does not help to better the quality of budgets.

Another problem is that, holding the amount of the deficit constant, authorities are differentiated only according to absolute current expenditure; the constraints ignore other factors in deficits, such as the incidence of capital expenditure and the fiscal effort. Further, the Pact sets out its constraints in absolute terms, thus failing to take account of differences in the size, population, or gross product of the various sub-national units. This constitutes a fundamental difference from the European Pact, whose constraints are all normalized as a percentage of GDP, and from the manner in which the other euro-area countries specify the contribution of single segments to the achievement of the overall external objective. What is more, the rules do not get at anomalous budget positions – possibly indicated by excessive spending on a per capita basis – but on the contrary preserve them, in that adjustment is proportional to the absolute value of the deficit.

Aside from greater flexibility, no significant correction can be expected from the use of the “mixed accrual” balance for 2008-2010. The result of the combination of two partial balances computed on two different bases can be erratic. And the new definition of the “mixed accrual” targets will certainly affect the behaviour of the local governments, which will seek to comply with the constraint by acting on current account items on the cash side and capital account items on the accrual side. The outcome is hard to forecast, and in any case a far cry from normal administrative practice.

Lastly, there is still no coordination with the constraints on debt, which is included only indirectly, and only for the past, in determining local public finance objectives. In fact, the average amount of asset disposals in 2003-2005 reduces the adjustment target by the amount allocated for early repayment of loans. This clause, which takes account of the effort made to reduce the debt in 2003-2005, offers no incentive for greater reductions in the future but is only a sort of ex-post reward, and quite a large one, given that disposals during the relevant years were substantial.

In conclusion, the new rules are complex, pursuing a multiplicity of aims: to mitigate the adverse effect that spending ceilings have had in the past, to make the domestic and external targets more similar, to differentiate the treatment of municipalities and provinces according to their fiscal virtue, and to avoid making local budgets excessively rigid, thanks to the expression of targets in terms of budget balances and the introduction of the “mixed accrual” basis for budget balances. The new version of the Domestic Stability Pact nevertheless has features that are not found in the experience of other euro-area countries and that are still far from instituting a true sharing of the external constraint.

6. Conclusion

The basic weakness of the controls imposed on Italian local government entities between 1999 and 2006 is the absence, nine years after the initial Domestic Stability Pact, of a well established, consolidated set of constraints, serving as an effective tool of control in the hands of central government but also as a planning instrument at the lower levels. In the sequence of variants of the Pact, one is struck by the variability of the adjustments required, very large in some years and much less in others; the weakness of monitoring and sanctions for non-compliance; the lack of an explicit agreement on the portion of the adjustment assigned to the central and to the local governments, so that the latter never had a clear overall result to attain. Further, the local entities are bound not only by the Pact but by other constraints as well, both on own revenue and on borrowing, and there is no coordination between these sets of rules and limits.

The approaches taken by other European countries are highly diversified as regards the definition of budget constraints, control and monitoring procedures, and sanctions. But a common course can be identified: a stronger tendency than in Italy to make the domestic rules consistent with the European Stability and Growth Pact.

In the euro-area countries, the degree of decentralization has affected the determination of domestic constraints and the results. Belgium and Germany, which are highly decentralized, have taken a cooperative approach, with good results in Belgium, less so in Germany owing to the large fiscal gap and a less clear assignment of responsibilities between levels of government. In Austria, the strictness and autonomy of budget policies are counterbalanced by the possibility of transferring portions of deficit from one entity to another. This mechanism has increased the involvement of local bodies in maintaining macroeconomic equilibrium, but the aggregate results have almost never fulfilled the planning targets. The adoption of a comparable system in Italy, in the current situation, would require a high degree of coordination, transparency and control over the budget trends of the authorities involved, but it would have the advantage of making the allocation of capital expenditure and debt more efficient (Giarda et al., 2005).

Perhaps the most suggestive experience is that of Spain, where the attribution of powers to the lower levels of government has been quite recent. The Domestic Stability Pact entails a rule set by the central government, but only after a phase of negotiations that has taken on added importance since 2005. However, Spain has a better balance than Italy between spending responsibility and fiscal autonomy. This narrows the fiscal gap, and in 2005 it made it possible to relax the rigidity of the rule by setting multi-year objectives and adopting a golden rule.

One factor that should be borne in mind in formulating a Domestic Stability Pact is suggested by the Belgian experience: the credibility of procedures, both in the fixing of objectives, which is done by independent forecasting methods, and in the phase of control and monitoring. In this context, one must not play down the elements of budget predictability and controllability that may be undermined by inconsistent accounting standards. Relying on an ex-post reconstruction of the accounts by ESA95 standards weakens the procedure for setting objectives and even more so that of budget control, which is often only partial. And above all, it does not result in a reliable valuation. These problems are found not only in Italy but also in Germany, whereas Belgium, Austria and Spain set their objectives with explicit reference to ESA95.

The fiscal rules introduced in Italy starting in 2007 will not significantly alter the constraints on the ordinary-statute regions, at least not until the experimental phase with the special-statue regions and provinces has been completed. In the future, this trial could lead to a different way of setting the fiscal rules. The rules for lower levels of government have been considerably changed, however. These authorities are now distinguished on the basis of budget outturns and bound to an objective defined in terms of the budget balance, practically without excluding any items. The objective is calculated as a correction to an average of past outturns, an “adjustment” that is the resultant of a dual proportional reduction, bearing on the average budget balance and average current expenditure. The limit on spending goes beyond simple compliance with the European Stability and Growth Pact, setting Italy’s domestic rules apart from those of many other European countries. As far as the objectives of various fiscal rules are concerned, this appears to be an implicit limit to the magnitude of the local public sector, which is probably necessary in Italy in that the true fiscal situation of the local entities is not completely expressed by their past budget balances.

The 2007 fiscal rule is totally inflexible, and if applied with a rigid budget balance constraint it requires a sharp correction in terms of own revenue and expenditure. To attenuate this rigidity, the rules for 2008-2010 have abandoned this correction for entities that, on the average, have had surpluses in the past and allowed the others broader scope for action by setting the objective in terms of a new, "mixed accrual" basis. This basis for calculating the balance, which is not used in the other European countries, is a pure accounting artifice designed to allow some flexibility, and it accentuates the difference between the variables used in actual budget management and those referred to in the Domestic Stability Pact. The issue of flexibility in the fiscal rules for local government, therefore, needs to be rethought; the design should be more transparent and should correspond better to administrative practice.

Finally, the constraints should take account of the volume of expenditures that the local administrations consider indispensable, which cannot be reduced beyond a certain point. As Bosi et al. (2003) suggested, this means determining an amount of resources that must be allocated to local governments to satisfy these spending needs sufficiently with respect to other governments at the same level and with respect to what can be considered a fair and adequate fiscal adjustment effort. The need, that is, is to design the Domestic Stability Pact not only in order for compliance with Italy's European commitments but also for consistency with the nature of Italian decentralization and the desired model of federalism.

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Appendix

The Domestic Stability Pact: Assessment of the Italian experience and comparison with the other EMU countries

Figure 1 **- Models of sharing an external objective at local level**

FIGURE 1a

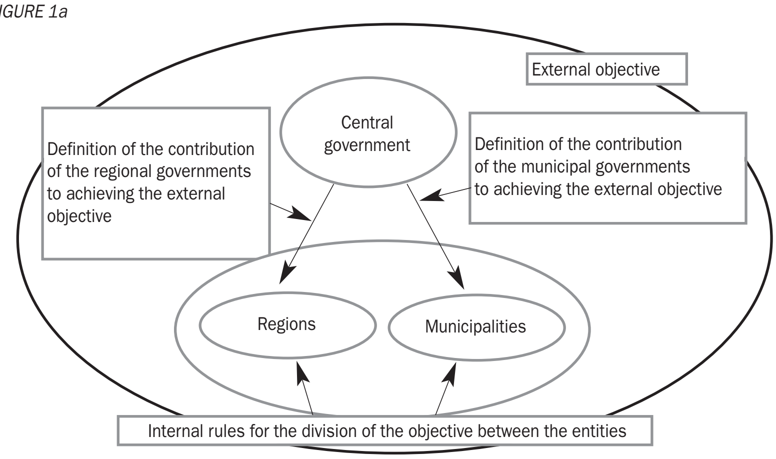

FIGURE 1b

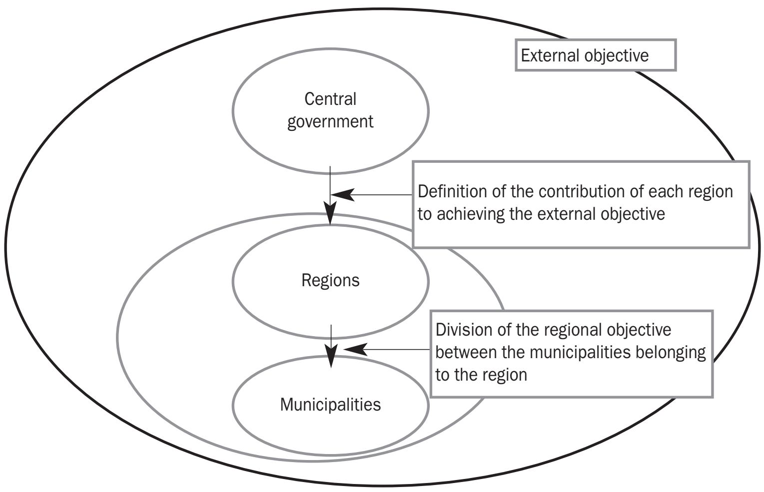

Table 1 – **General government net borrowing and debt by government level in selected EMU countries** ***(as a % of GDP)***

	Net borrowing			**Debt**		
Federal countries	**1995**	**2001**	**2005**	**1995**	**2001**	**2005**
Austria	-5.6	0.0	-1.5	67.9	66.0	63.5
Central gov't.	*-5.2*	*-0.7*	*-1.8*	*nd.*	*n. d.*	*59.6*
States/regions	*0.1*	*0.5*	*0.1*	*n. d.*	*n. d.*	*3.0*
Local gov'ts.	*-0.5*	*0.3*	*0.2*	*n. d.*	*n. d.*	*2.0*
Belgium	-4.4	0.6	-2.3	129.8	106.5	92.1
Central gov't.	*-3.7*	*-0.8*	*-2.4*	*118.1*	*100.0*	*85.8*
States/regions	*-0.8*	*0.8*	*0.3*	*9.1*	*6.5*	*4.3*
Local gov'ts.	*0.3*	*-0.1*	*-0.1*	*6.0*	*5.5*	*5.2*
Germany	-3.3	-2.8	-3.4	55.6	58.8	67.8
Central gov't.	*-1.9*	*-1.3*	*-2.1*	*n. d.*	*n. d.*	*41.6*
States/regions	*-1.1*	*-1.3*	*-1.0*	*n. d.*	*n. d.*	*21.5*
Local gov'ts.	*0.0*	*-0.1*	*0.0*	*n. d.*	*n. d.*	*5.3*
Spain	-6.5	-0.6	1.0	62.7	55.5	43
Central gov't.	*-5.5*	*-0.8*	*0.2*	*n. d.*	*n. d.*	*36.4*
States/regions	*-0.6*	*-0.6*	*-0.3*	*n. d.*	*n. d.*	*6.3*
Local gov'ts.	*0.0*	*0.0*	*-0.1*	*n. d.*	*n. d.*	*2.8*
Unitary countries						
Finland	-6.2	5.0	2.9	56.7	42.3	41.3
Central gov't.	*-11.3*	*1.9*	*0.6*	*n. d.*	*n. d.*	*39.1*
Local gov'ts.	*1.3*	*-0.4*	*-0.6*	*n. d.*	*n. d.*	*5.3*
France	-5.5	-1.5	-2.9	55.5	56.9	66.4
Central gov't.	*-4.5*	*-2.1*	*-2.6*	*45.2*	*51.0*	*59.8*
Local gov'ts.	*-0.2*	*0.1*	*-0.2*	*9.3*	*7.1*	*7.0*
Italy	-7.4	-3.1	-4.2	121.2	108.7	105.8
Central gov't.	*-7.5*	*-3.1*	*-3.8*	*119.5*	*104.7*	*99.9*
Local gov'ts.	*0.1*	*-0.3*	*-0.9*	*5.2*	*3.3*	*6.3*
Netherlands	-1.9	-0.2	-0.3	76.1	50.7	54.8
Central gov't.	*-1.5*	*-0.2*	*0.1*	*n. d.*	*n. d.*	*46.8*
Local gov'ts.	*0.2*	*-0.1*	*-0.2*	*n. d.*	*n. d.*	*8.0*

Source: Based on Eurostat and Bank of Italy data.

Table 2 – Expenditure decentralization and fiscal autonomy in selected EMU countries

	Local expenditure				Local tax revenue						Revenue with autonomy on total local revenue	
	% of total expenditure		% del GDP		% of total local revenues		% del GDP		% of total local revenues			
	2005	Change 1995-2005	2005	Change 1995-2005	2005	Change 1995-2005	2005	Change 1995-2005	2005	Change 1995-2005	Rates and reliefs	Rates and reliefs
FEDERAL COUNTRIES												
Austria	34.8	-0.1	17.4	-2.1	18.9	-2.7	8.2	-1.0			7.0	
States/regions	18.8	2.8	9.4	0.4	7.8	-1.2	3.4	-0.4	35.1	-7.1	2.7	5.4
Local gov'ts	16.0	-2.9	8.0	-2.5	11.1	-1.5	4.8	-0.6	58.9	5.5		
Belgium	42.2	4.0	20.9	1.1	13.0	3.4	6.0	1.7			100.0	
States/regions	28.3	2.5	14.0	0.6	7.5	3.5	3.5	1.7	24.6	10.3	46.6	51.3
Local gov'ts	13.9	1.5	6.9	0.5	5.5	-0.2	2.5	0.0	37.6	-0.1		
Germany	43.1	3.9	20.2	-1.2	29.8	0.7	11.9	0.2				2.4
States/regions	27.5	3.2	12.9	-0.4	22.4	-0.3	8.9	-0.2	75.0	0.0	17.6	33.6
Local gov'ts	15.6	0.7	7.3	-0.8	7.5	1.0	3.0	0.4	41.0	7.9		
Spain	53.4	17.5	20.5	4.5	30.6	17.2	11.1	6.6			53.7	
States/regions	37.8	15.1	14.5	4.4	21.9	17.1	7.9	6.3	55.4	38.9	2.9	74.5
Local gov'ts	15.6	2.5	6.0	0.1	8.8	0.0	3.2	0.3	53.0	3.8		
UNITARY COUNTRIES												
Finland	39.4	6.2	19.9	-0.6	20.8	-2.0	9.1	-1.3	47.3	-0.4		89.9
France	20.4	2.2	10.9	1.0	10.6	0.2	4.8	0.2	44.8	-2.6	72.0	17.8
Italy	32.5	7.7	15.5	2.6	16.0	8.2	6.5	3.3	44.2	19.4		66.4
Netherlands	35.2	-5.4	15.9	-7.0	5.2	0.6	2.0	0.1	12.8	4.7		100.0

Source: Based on Eurostat and Bank of Italy data.

Table 3 – **The characteristics of the budget constraints applied in the EMU countries**

				Austria	Germany	Spain	France	Belgium	Finland	Netherlands
Constraint	on the budget balance			✓	✓	✓	✓	✓	✓	✓
	on expenditure			✓			✓			
	on fiscal autonomy									
	on the debt			✓	✓	✓	✓	✓	✓	✓
Decision on the constraint	imposed or negotiated but mandatory			✓		✓	✓		✓	
	self-imposed or non-mandatory				✓			✓		✓
	With reference to	Annual budget			✓		✓		✓	
		Multi-year budget		✓		✓		✓		✓
	Instruments to offset the cycle or shocks	Safeguard clauses		✓	✓					
		Financial support					✓			
		Cuts in mandatory expenditure			✓					
Constraint on the debt	Restrictions on access to	Financing for current and capital expenditure			✓		✓			
		Financing for capital expenditure alone		✓		✓				
	Type of constraint	Numerical			✓	✓				
		Non-numerical		✓			✓			
	Safeguard clauses	Present								
		Not present								
Application of the rule	Monitoring	Responsible entity	Higher government entity			✓	✓			✓
			Higher sub-national entity		✓	✓				✓
			Other	✓	✓	✓	✓			✓
		Frequency of data transmission					✓			✓
	Transparency	Standardization of the budgetary data transmitted			✓	✓				
		Independent audit		✓			✓	✓		✓
	Sanctions	Financial sanctions		✓	✓	✓	✓	✓	✓	✓
		Mandatory measures		✓	✓	✓	✓	✓	✓	✓

Table 4 – **Characteristics of decentralization in Italy relevant to choice of sub-national fiscal rule**				
			Regions	**Municipalities and provinces**
Tax authonomy	Revenue responsibility (own revenues as % of total)		48.8	32.9
	Tax revenue according to possibility of control (% of total)	Control of rates and tax base	61.0	84.9
		Revenue sharing	5.0	
		None	34.0	15.1
Expenditure	Expenditure responsibility (% of total gen'l gov't)		21.6	10.9
	Politically sensitive spending (% of total by function)	Education	12.3	14.1
		Health	98.4	
		Welfare (excl. pensions)	1.9	13.1
	Current expenditure exempt from Pact (%) - 2005		13.9	58.8 (Provinces) 61.3 (Municipalities)
	Capital expenditure as % of final expenditure (%) - 2005		16.2	27.9
	Gross fixed investment as % of gen'l gov't expend (%) - 2005		14.3	8.0 (Provinces) 45.9 (Municipalities)
	Degree of structural rigidity % (*)		37.9 (30.6)	51.0 (31.2) Municipalities 34.9 (23.0) Provinces

(*) Defined as: (staff costs + debt service) / current revenue; in brackets, staff costs as percentage of current revenue.

Table 5 – **The Domestic Stability Pact in Italy: Characteristics of the fiscal rules**

			1999-2000	2001	2002	2003-04	2005-06	2007-10
Scope (percentage of all entities subject)		Ordinary-statute regions	100%	100%	100%	100%	100%	100%
		Local government entities	100%	100% Provinces 29% Munic. (82 % pop.)	100% Provinces 29% Munic. (82 % pop.)	100% Provinces 29% Munic. (82 % pop.)	Munic: 43% in 2005 29% in 2006 Other local	29% Munic. (82 % pop.)
Decision on constraint		Imposed or negotiated (mandatory)	✓	✓	✓	✓	✓	✓
		Self-imposed or non-mandatory						
Regions	Type of constraint	on the budget balance	✓	✓				
		on expenditure			✓	✓	✓	✓
		on the debt	✓					
	Budget balance	Partial coverage	✓	✓				
		Exemption of capital expenditure	✓	✓				
		With reference to Annual budget	✓	✓				
		Multi-year budget						
		Instruments to offset cycle or shocks						
	Expenditure	Partial coverage			✓	✓	✓	✓
		Exemption of capital expenditure			✓	✓		✓
	Outsourcing activities to other entities	Envisaged explicitly			✓			
Local entities	Type of constraint	on the budget balance	✓	✓	✓	✓		✓
		on expenditure			✓		✓	
	Budget balance	Partial coverage	✓	✓	✓	✓		
		Exemption of capital expenditure	✓	✓	✓	✓		
		With reference to Annual budget	✓	✓	✓	✓		✓
		Multi-year budget						
		Instruments to offset cycle or shocks						
	Expenditure	Partial coverage					✓	
		Exemption of capital expenditure			✓			
	Outsourcing activities to other entities	Envisaged explicitly			✓			

continues

Table 5 – **The Domestic Stability Pact in Italy: Characteristics of the fiscal rules**

continued				1999-2000	2001	2002	2003-04	2005-06	2007-10
Application	Monitoring	Entity responsible	Higher-level gov't	✓		✓	✓	✓	✓
			Other sub-nat'l gov't		State-regions and State-local conference				
		Data transmission frequency		Monthly	Quarterly	Quarterly	Quarterly	Quarterly or half-yearly depending on size of entity	Quarterly
		Entities for which it is mandatory		Regions, and large local gov'ts	Regions, provinces, munic. over 60,000 pop.	Regions, provinces, munic. over 60,000 pop.	Regions, provinces, munic. over 60,000 pop.	All	All
	Transparency	Standardization of data					✓	✓	✓
		Independent audit		✓		✓	✓	✓	✓
	Sanctions	Financial sanction		Sanctions:1999 Incentives: 2000	Incentives	✓			
		Mandatory measures					✓	✓	✓
		Public list non-compliant auth.							✓
	CONSTRAINTS OUTSIDE PACT								
Constraints on tax autonomy	Limits on range of tax rates			✓	✓	✓	✓	✓	✓
	Tax rate freeze					✓	✓		
	Restrictions on access to financing	Fin.for current and capital exp.							
		Financing allowed only for capital expenditure		✓	✓	✓	✓	✓	✓
Constraints on the debt	Type of constraint	Numerical							
		Non-numerical							
		Based on cost of debt service		✓	✓	✓	✓	✓	✓
	Administrative constraint			✓	✓	✓	✓	✓	✓
	Ban on guarantees from higher level of gov't			✓	✓	✓	✓	✓	✓

Table 6 **– General government and local authority net borrowing and debt, 1999-2006 *(% of GDP)***

	1999	2000	2001	2002	2003	2004	2005	2006*
NET BORROWING/GDP								
Central gov't	1.45	1.14	3.09	2.99	2.96	2.94	3.82	2.72
Local authorities	0.59	0.14	0.28	0.81	0.45	0.98	0.85	1.13
Regions	*0.21*	*-0.18*	*0.12*	*0.03*	*-0.06*	*0.31*	*0.08*	*0.54*
Provinces	*0.04*	*-0.01*	*0.04*	*0.11*	*0.10*	*0.14*	*0.11*	*0.11*
Municipalities	*0.28*	*0.23*	*0.23*	*0.29*	*0.31*	*0.27*	*0.18*	*0.11*
Local health units	*0.14*	*0.18*	*-0.02*	*0.34*	*0.04*	*0.24*	*0.45*	*0.25*
Other local entities	*-0.08*	*-0.08*	*-0.08*	*0.04*	*0.05*	*0.02*	*0.04*	*0.11*
Soc. sec. inst's	-0.31	-0.45	-0.29	-0.93	0.08	-0.45	-0.44	-0.49
GEN'L GOV'T	**1.73**	**0.84**	**3.08**	**2.86**	**3.49**	**3.47**	**4.23**	**3.36**
NET BORROWING COMPOSITION OF RATE OF INCREASE								
Central gov't	-25.26	-14.05	250.88	0.20	2.26	3.06	28.11	-23.65
Local authorities	13.30	-25.39	18.30	18.04	-12.00	16.41	-3.01	7.48
Regions	*8.24*	*-23.23*	*36.68*	*-2.74*	*-3.18*	*11.03*	*-6.79*	*11.53*
Provinces	*0.72*	*-2.81*	*6.02*	*2.30*	*-0.33*	*1.43*	*-0.93*	*0.18*
Municipalities	*1.19*	*-2.37*	*1.39*	*2.47*	*1.12*	*-1.09*	*-2.29*	*-1.52*
Local health units	*4.81*	*3.25*	*-24.58*	*12.00*	*-10.11*	*5.94*	*6.33*	*-4.48*
Other local entities	*-1.66*	*-0.23*	*-1.20*	*4.01*	*0.51*	*-0.90*	*0.67*	*1.77*
Soc. sec. inst's	-23.90	-9.61	17.30	-21.92	35.43	-15.83	-0.02	-1.69
GEN'L GOV'T	**-35.86**	**-49.04**	**286.48**	**-3.68**	**25.70**	**3.64**	**25.08**	**-17.86**
DEBT/GDP								
Central gov't	110.70	105.35	104.74	101.54	98.72	98.16	99.86	99.46
Local authorities	2.90	3.29	3.32	3.59	5.35	5.54	6.33	7.33
Debt Regions	*1.31*	*1.49*	*1.54*	*1.72*	*2.07*	*2.19*	*2.40*	*3.06*
Debt Provinces°	*n.d.*	*0.12*	*0.13*	*0.15*	*0.36*	*0.41*	*0.51*	*0.59*
Debt Municipalities	*1.31*	*1.29*	*1.26*	*1.29*	*2.50*	*2.54*	*2.87*	*3.07*
Debt other local entities	*0.28*	*0.38*	*0.39*	*0.43*	*0.42*	*0.40*	*0.55*	*0.61*
Soc. sec. inst's	0.01	0.51	0.64	0.42	0.21	0.10	0.00	0.00
Debt GEN'L GOV'T	**113.62**	**109.16**	**108.70**	**105.56**	**104.27**	**103.80**	**106.20**	**106.79**
DEBT: COMPOSITION OF RATE OF INCREASE								
Central gov't		0.55	4.08	0.54	0.22	3.35	3.89	3.07
Local authorities		0.51	0.17	0.38	1.82	0.40	0.90	1.19
Debt Regioni		*0.23*	*0.12*	*0.22*	*0.39*	*0.20*	*0.25*	*0.73*
Debt Provinces°		*0.12*	*0.01*	*0.03*	*0.21*	*0.06*	*0.11*	*0.09*
Debt Comuni		*0.05*	*0.02*	*0.08*	*1.21*	*0.14*	*0.38*	*0.29*
Debt other local entities		*0.11*	*0.03*	*0.05*	*0.01*	*0.00*	*0.15*	*0.08*
Soc. sec. inst's		0.46	0.15	-0.18	-0.20	-0.09	-0.10	0.00
Debt GEN'L GOV'T		**1.53**	**4.40**	**0.73**	**1.84**	**3.66**	**4.70**	**4.26**

Sources: Based on data from Istat, Conti ed aggregati economici delle Amministrazioni Pubbliche (June 2008) and Banca d'Italia, Supplementi al Bollettino Statistico – Finanza Pubblica, Nos. 61-06, 62-07 and 17-08, and Banca d'Italia annual reports, various years.
* The data for 2006 have been revised (Istat, press release of 29 Feb. 2008) downwards to 3.4 per cent of GDP; but disaggregation by level of government is not yet available.

Table 7 – Calculation of target budget balances for municipalities				
2008 Finance Law				
	Deficit municipalities AB< 0		**Surplus municipalities AB> 0**	
Criterion for application of adjustment cap/reduction	α |AB |+ β curr.B > 0.08 Final B		$\Delta > 0$	
	Cap not applicable	**Cap applicable**	**Reduction not applicable**	**Reduction applicable**
Annual adjustment	α |AB |+ β curr.E	0.08 FinalE. = 0.08 (curr.E + cap.E)	0	[Δ- β curr.E] if >0
Target balance	Bmix (1 + α)+ β curr.E– x Disp.	AB + 0.08 Final E. - x Disp.	Smix- x Disp	Smix - [Δ- β curr.E]

Notes. The values of α are set at 0.205 for 2008 and 0.155 for 2009 and 2010. The values of β are set at 0.017 for 2008 and 0.013 for 2009 and 2010.
AB: average, 2003-2005, of balance on a cash basis. B*mix*: average, 2003-2005, of balance on a mixed accrual basis. *Curr.E.*: average, 2003-2005, current expenditure on a cash basis (Title I). *Final E:* average, 2003-05, of final expenditure. *Cap.E.:* average, 2003-2005, capital expenditure (Title II). *Disp:* average, 2003-2005, of capital revenue on a cash basis from disposals of real estate and other assets x: share of disposals allocated to early repayment of loans. Δ = [(1-x) Disp - 0,15 fR], where *f*R is final revenue.